For release on delivery
1:00 p.m. EST
March 3, 1993

Remarks of

Susan M. Phillips
Member, Board of Governors of the Federal Reserve System

at the

Conference on Regulation of Derivative Products
Institute for International Research

March 3, 1993
New York, New York

Thank you for providing me with the opportunity to participate in your program. Your topics are most interesting and timely. As I'm sure you are aware, the regulation of derivative products has received considerable attention in Washington the last few years and remains a hot issue.

Your speakers this morning have discussed at length the Commodity Futures Trading Commission's recent actions to exempt swaps and similar OTC derivatives from regulation under the Commodity Exchange Act. This action followed several years of intense debate and then, finally, enabling legislation. In my view, the CFTC's action contributed importantly to reducing legal risks in the derivatives markets and to facilitating efforts to mitigate credit risks in these markets. But I doubt that anyone regards the action as a final resolution of the issues that have arisen regarding the appropriate application of the commodities laws to the OTC derivatives markets. In particular, the Congress has directed the CFTC to prepare a thorough study of the appropriate regulatory structure for derivatives. The study is scheduled to be completed this fall, at which point the Congress may revisit these issues.

While I intend to return to the CFTC issues toward the end of my remarks, today I thought that it would be most useful for me to comment on the Federal Reserve's interest in the derivatives markets. In particular, I will focus my address primarily on supervisory policies relating to banks' use of derivative products and on payment and settlement system policies. Both sets of policies are intended to encourage developments that reduce risks to individual financial institutions and to the financial system as a whole.

The Riegle Study

The Federal Reserve's interest in the derivatives markets has been heightened by banks' increased use of these markets. The Congress also has been interested in the implications of this development for bank safety and soundness. In particular, last fall the bank regulatory agencies received a request from Senator Riegle, Chairman of the Senate Banking Committee, for a study of U.S. banks' derivative products activities. The study, which was released in late January, describes the instruments involved, the risks associated with their use, and relevant banking supervision and payment system policies. Perhaps the study's most important conclusion is that regulation cannot substitute for effective risk management. The risks associated with derivatives--counterparty credit risks, market risks, and operational risks--are the same types of risks that banks are accustomed to managing in their traditional activities. But derivatives combine these risks in especially complex ways. Thus, banks that are highly active in the derivatives markets must develop new risk measurement methodologies, stronger risk controls, and better management systems.

The study notes that to date managements of the large banks that account for the vast bulk of derivatives activities have successfully met this challenge. Derivatives activities appear to have generated substantial profits for these banks and apparently no serious losses. Nonetheless, as the study concludes, we must not be complacent. To keep pace with continued innovation and growth in their derivatives activities, banks and their senior management need to continue to review and enhance their policies, procedures, and information systems for managing and controlling risks.

Efforts by the Federal Reserve to Enhance Supervisory Policies

The Riegle study also stresses that banking regulators must continue their own efforts to improve their supervisory policies and procedures to ensure that banks take the necessary steps to manage the risks associated with derivatives activities prudently. Indeed, this is a priority of the Federal Reserve and a variety of projects are underway to strengthen supervision and regulation of banks' derivatives activities.

A major focus of these efforts centers around capital adequacy. You are probably all familiar with the capital requirements developed by the Basle Supervisors committee that apply to credit risks on derivatives. These capital requirements continue to undergo review, and I anticipate that the Basle Supervisors will act soon to recognize the reduced credit exposures that are achieved through legally enforceable netting arrangements.

However, the precise way in which netting is recognized is likely to be a focus of continuing debate. Measuring the potential change in credit exposure on a portfolio of contracts subject to a bilateral netting agreement is extremely complex. The Federal Reserve is continuing to study these measurement issues, with the hope of developing better risk measures of potential exposure in a netting environment. We are also studying ways to measure more accurately the risks embodied in commodity and equity swaps and options and other new types of derivatives.

The Basle Supervisors also have been working to develop capital requirements for market risk, and they hope to share some proposals with market participants in the next few months. Because derivatives play an important role in the management of market risk, those proposals will, of course, address the measurement of market risks associated with derivatives. I expect, however, that the proposed measurement schemes will not address the market risks associated with options trading in a fully satisfactory way and that further refinements will be necessary.

Federal Reserve staff members have been considering a variety of approaches to establishing capital requirements for portfolios that include significant options components. As a former commodities regulator, one approach that I believe is particularly promising adapts the procedures developed by U.S. futures exchanges for establishing margin requirements for portfolios of futures and options on futures. Analytically margin and capital issues have important similarities. In each case, the goal is to assess the likelihood that adverse price movements could produce portfolio losses. A special virtue of the futures exchanges' approach is that it explicitly allows for the possibility that dynamic hedges of options positions may perform poorly in circumstances where illiquid markets preclude timely adjustments of hedge positions.

Capital requirements are an essential element of our supervisory approach to OTC derivatives because capital ultimately serves as a buffer to absorb losses. But in my view a far more immediate, though less visible, element is our program of on-site examination of banking organizations. The Federal Reserve is currently conducting a thorough review of its examination policies and procedures relating to derivatives. This review is expected to result in new examination guidelines, not only for derivatives products, but also the trading and hedging activities of banks in general. These new guidelines will then be incorporated into our examiner training programs.

Finally, the Federal Reserve is reconsidering accounting and reporting standards for derivatives. The fact that generally accepted accounting principles (GAAP) do not currently address interest rate swaps, or many other types of OTC derivatives, is clearly a cause for concern. Nor have reporting requirements generally kept pace with market developments. I would note, however, that the disclosures made by banking organizations generally are more thorough than those made by other OTC derivatives market participants. Indeed, the absence of accounting standards and the tendency for reporting to appear uninformative may have contributed to the criticisms and concern about derivatives activities that have arisen in segments of the financial press, the regulatory community, and the Congress.

Efforts by the Federal Reserve to Strengthen Payment and Settlement Systems

In addition to its bank supervisory responsibility, as the nation's central bank, the Federal Reserve has broad responsibility for maintaining the stability of financial markets and payment and settlement systems and for containing systemic risks. Some regulators have expressed concerns that derivatives trading is a potential source of systemic risks. The Federal Reserve has attempted to limit systemic risks in the OTC derivatives markets in two basic ways. First, as already mentioned, we are exercising our authority as a banking supervisor to attempt to ensure that derivatives activities by entities subject to our supervision are not a source of systemic risk. Second, together with other central banks, we have encouraged efforts to strengthen payment and settlement systems so that these systems act to contain potential systemic problems rather than to transmit such problems to other markets and institutions.

Perhaps the most important action taken thus far in the payment system policy area has been the encouragement that the Federal Reserve and other central banks have given to the development of sound arrangements for netting OTC derivative contracts. In November 1990, the BIS published the Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries (the Lamfalussy Report). The main conclusion of that report was that netting schemes have the potential to reduce systemic risk, provided certain conditions are met. The report set out minimum standards that cross-border and multicurrency netting and settlement schemes must meet if they are to reduce systemic risk.

In a domestic context, the Federal Reserve has taken several further actions to encourage the development of sound netting arrangements. First, it has supported a series of legislative changes that have reduced uncertainty with respect to the netting of derivative contracts by many market participants in the United States. These changes include amendments to the bankruptcy code, provisions of FIRREA affecting the treatment of netting contracts by the FDIC as receiver of failed depository institutions, and a far-reaching provision of FDICIA that validated explicit netting agreements between and among financial institutions. Second, the Federal Reserve has supported the provisions of the Futures Trading Practices Act of 1992 that clarified the authority of the CFTC to exempt OTC derivatives from Commission regulation.

As I noted at the outset and as I am sure you will discover during the course of this program, the appropriate scope of exemptions of OTC derivatives from CFTC regulation remains a hotly debated issue. The Board supported the action that the CFTC took in January, viewing it as a significant improvement over the policy statement that had been in effect previously. In particular, the new regulation constituted another important step in the direction of greater legal certainty with respect to OTC derivative transactions. It also removed impediments to the use of bilateral collateral or margining arrangements that had been contained in the earlier policy statement.

Additionally, although the CFTC stopped short of permitting the development of multilateral netting systems (clearing houses) for OTC derivatives, it acknowledged that a clearing house system for OTC derivatives could be beneficial to market participants and to the public generally. The Commission also indicated that it intends to provide market participants maximum latitude in developing multilateral netting mechanisms that reduce systemic risk. Thus, the Commission appears to have reached conclusions with respect to netting arrangements that are broadly consistent with the conclusions expressed in the Lamfalussy Report.

We should not minimize the difficulties involved in developing a swaps clearing house that addresses the systemic risk concerns highlighted in the Lamfalussy Report. However, I believe the potential benefits of a clearing house should be explored by market participants. Multilateral netting is a potentially powerful tool for reducing counterparty credit exposures. With the continued growth of OTC derivatives, concerns about the concentration of counterparty credit risks are likely to become an increasingly important issue when entering into new transactions, particularly in the interdealer markets. While some highly creditworthy swap dealers may fear that the creation of a clearing house would harm their competitive position, it is not clear to me why a clearing house that served the dealer community would in any way erode the advantage that highly rated dealers have in competing for the business of end-users. Such end-users still would have incentives to deal with the most creditworthy dealers, while the clearing house would allow such dealers to reduce credit exposures and related capital changes in the interdealer market.

Developing a swaps clearing house, however, is not the only step, or even necessarily the most important step, that could be taken to reduce systemic risk in derivatives markets. Perhaps the largest single source of credit exposures in the derivatives markets is the settlement exposures created by foreign exchange contracts. The lack of a delivery-versus-payment mechanism for foreign exchange contracts exposes participants in these markets to the risk of loss of the full principal value of the contract in the event of a counterparty's failure. This risk is often termed "Herstatt risk" in reference to the foreign exchange settlement losses suffered by many banks as a result of the failure of Bankhaus I.D. Herstatt in 1974.

As in the case of interest rate swaps, development of a multilateral netting system is one promising approach to reducing Herstatt risks by reducing the volume of funds transfers needed to settle a given volume of foreign exchange trades. I understand that there are two groups of bankers, one in North America and the other in Europe, working to design and implement foreign exchange clearing houses that meet the Lamfalussy standards.

The Federal Reserve and other central banks have been considering possible measures that central banks might take--either individually or on a cooperative basis--to improve efficiency and reduce risks (including Herstatt risks) in the settlement of foreign exchange transactions. For example, the Federal Reserve requested comment last fall on how expansions of operating hours for the Fedwire funds transfer system might provide opportunities for the private sector to reduce the risks associated with foreign exchange settlements. Many comments were received, and staff are currently evaluating the analysis and suggestions in these letters.

Conclusion

I think you can see from my remarks today that the Federal Reserve has in train quite a few projects intended to enhance our bank supervisory and payments system policies relating to derivatives. This activity should not be interpreted as reflecting alarm at the growth and further development of derivatives markets or as portending a flood of new regulations. Rather, it reflects a belief that opportunities exist for market participants to strengthen risk management policies and procedures as well as derivative market infrastructures. Hopefully, encouragement from policymakers can help assure that these opportunities are not missed. At the same time, regulators must also assure that their own supervisory policies and procedures keep pace with market developments to minimize financial systemic risks.

Thank you.